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Bell Atlantic

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By Hand

The Honorable William E. Kennard
Chairman
Federal Communications Commission
1919 M Street, NW -- Room 814
Washington, D.C. 20554

Re: Reciprocal Compensation for Internet Traffic

Dear Chairman Kennard:

The payment of reciprocal compensation for Internet-bound calls is distorting the market, undermining competition in residential telephony, and discouraging the deployment of high-speed networks.

Therefore, there is an urgent need for action by the Federal Communications Commission to confirm that Internet-bound calls are not local calls, and are not subject to the payment of reciprocal compensation.

Based on a mistaken interpretation of this Commission's prior orders, state commissions have classified calls bound for the Internet – and through it to other Internet users around the globe – as "local" calls. These decisions require telephone companies that provide local service to residential and other dial-up users of the Internet to pay "reciprocal" compensation when these calls are handed off to another carrier for delivery to an Internet service provider.

As one independent analyst puts it, this creates the "single greatest arbitrage opportunity and hence market distortion in the telecom sector today;" deters competition for residence and other dial-up users of the Internet because it has the "perverse effect of turning customers from assets into liabilities;" and discourages economically sound investment. (Attachment 1).

Reciprocal compensation pays carriers not to compete. Because it is available only when a customer's line is served by another carrier, Internet reciprocal compensation actually pays carriers not to invest in their own competing facilities and not to provide their own competing service to residence or small business customers.

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The reason is simple: If competing carriers sign up residential or other dial-up Internet users for their own local services, they can kiss the risk-free cash from reciprocal compensation on those lines goodbye. Plus, they then have to pay reciprocal compensation when they hand off calls to another carrier for delivery to an Internet service provider.

The amount that carriers are being paid to not compete has ballooned along with the use of the Internet. Bell Atlantic alone will pay more than $150 million during 1998 and more than $300 million during 1999. The overwhelming majority of this money, roughly three-quarters in our case, currently goes to only two massive combines – Worldcom/MCI and AT&T/TCG.

Ironically, if a family or small business uses the Internet for as little as two hours a day, the reciprocal compensation typically totals more than the customer pays for the line. And if the customer leaves its computer connected to the Internet all the time, the reciprocal compensation can total $300 per month.

The ability to receive this kind of windfall deters competition, and at the same time creates an enormous drain on companies that have made the investment necessary to provide local service.

Reciprocal compensation pays people money for nothing. The ability to get reciprocal compensation without providing local dial tone service to even a single customer distorts behavior in other ways.

For example, Internet service providers have begun setting up shop as "carriers" for the sole purpose of getting paid reciprocal compensation for the Internet traffic that is delivered to them. One example is illustrative: During the first quarter of this year alone, just one of these "carriers" that provides no dial tone to anyone, sends essentially no traffic to us, and whose customer service representative says is not offering local telephone service, collected several million dollars in reciprocal compensation – all to provide the same Internet service it provided before it re-labeled itself a "carrier."

The payment of Internet reciprocal compensation has so distorted incentives that, region-wide, the number of minutes we hand off to competing carriers is approaching ten times the number of minutes they send to us. In some of our states, the ratio is more than fifty to one. These ratios are driven, of course, by the carriers' increasing focus on fronting for Internet service providers in order to get the easy cash from reciprocal compensation.

The lure of free cash also inspires conduct bordering on fraud. Because reciprocal compensation is available only for calls that begin and end in the same local calling area, some carriers have assigned multiple blocks of numbers to Internet service providers – each attributable to a different local calling area – in order to make calls to those providers from distant calling areas appear "local." In fact, one Internet service provider cum carrier has locked up well over 100 NXXs – representing over a million numbers – all without a single local telephone customer.

These illicit activities only exacerbate the problem, deprive the originating carriers of toll revenues they are entitled to, and contribute to the rapid exhaustion of numbers to boot.

Reciprocal compensation deters investment. The payment of reciprocal compensation not only deters investment in local facilities by competitors, it also deters investment by all carriers in new technologies that could be used to handle this traffic more efficiently.

Although Internet-bound traffic could be handled more efficiently by moving it off the circuit-switched network, and onto more efficient packet-switched technologies, there is no incentive to deploy these technologies if they won't be used. But the fundamental problem is that, as long as Internet service providers (or their carrier affiliates) can get paid reciprocal compensation if they stay on the circuit-switched network, they have little incentive to move to new packet-switched technologies, no matter how reasonably priced. And so long as no one is willing to use these new technologies, there is little incentive for originating carriers to deploy them in the first place.

In light of these facts, the Commission must act now to correct the mistaken interpretation of its orders by the state commissions that have classified Internet calls as local.

As the attachment explains in further detail, while the Commission did exempt Internet and other enhanced service traffic from the payment of interstate access charges, it consistently has held that the traffic remains interexchange and interstate in nature – not local. (Attachment 2). Indeed, if this were not the case, there would be no need for an access charge "exemption," and the Commission would have had no jurisdiction to create one to begin with.

As a result, we urge you to quickly adopt an order in response to the petition filed by ALTS last summer declaring that, under the Commission's prior orders, Internet-bound traffic is not "local" and is not subject to reciprocal compensation.

We would appreciate the opportunity to meet with you to discuss this further.

Sincerely,

Edward D. Young, III
Senior Vice President &
Deputy General Counsel

Thomas J. Tauke
Senior Vice President
Government Relations

cc: Commissioner Furtchgott-Roth
Commissioner Ness
Commissioner Powell
Commissioner Tristiani
Kathy Brown

Attachment 1

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June 24, 1998

Reciprocal Comp For Internet Traffic--Gravy Train Running Out Of Track

(Part V of Internet Regulation Preview Series)

Summary: In a classic case of what you see is not necessarily what you get, **investors should not expect the current reciprocal compensation arrangement for Internet traffic to continue much past the end of the year.** Given that this issue is probably the single greatest opportunity for arbitrage in the whole sector, over 4,000 percent in some instances, **TPG cautions investors that this extraordinary arbitrage "gravy train" will run out of track--probably this year.** It is simply not sustainable long-term.

Moreover, investors should not be lulled into a false sense of security that 19 consecutive state public utility commissions have ruled (in addition to a recent Federal Court in Texas) that Internet service provider (ISP) traffic passed through a competitive local exchange carrier (CLEC) is classified as a local call. In the coming months, **TPG expects the FCC to trump these state decisions by clarifying that Internet traffic is indeed interstate, effectively reasserting its federal jurisdiction over data or Internet transport.** *(Reciprocal compensation is a regulatory arrangement where local telecom providers pay each other for "the cost" of terminating the calls they originate. In most cases, reciprocal compensation traffic is two-way and thus largely offsetting. However, since Internet/data traffic is one-way, there is little "reciprocal" about this arrangement. It is just a regulatory compensation windfall for CLECs/ISPs.)*

A Big Deal for Investors: This reciprocal compensation arbitrage is a **significant part of the existing "data growth engine" of many CLEC and ISP business models.** Consequently, investors need to be aware that in some instances, short-term projected results may be **artificially "juiced up," potentially providing an illusion of faster-than-real long-term growth**. The flip side of this problem is that reciprocal compensation is a **significant and growing liability, primarily for the Baby Bells.** It is growing at such a rapid rate that it could be a significant threat to earnings roughly in 1999, if not fixed by the FCC by then.

Why the FCC Will Fix It: First, reciprocal compensation for one-way Internet traffic is arguably the **single greatest arbitrage opportunity and hence market distortion in the telecom sector today.** TPG flagged this important issue in our April 6 *"Internet Regulation Preview"* bulletin as akin to a broken bank ATM machine that only allows withdrawals and takes no deposits. No other place in the sector can companies reap as much as a 4,000 percent arbitrage for minimal, value-added service. No competitive market, legal or illicit, can generate such gargantuan arbitrage. Only regulatory distortions can generate this size arbitrage over an extended period of time.

Second, this arbitrage opportunity is **greatly contributing to an artificial misalignment of the market structure** of this newly emerging competitive voice/data niche. Reciprocal compensation is driving many alliances, mergers and acquisitions for purely regulatory and not economic or competitive reasons. Thus, in some instances, an ISP is currently an asset to a CLEC, but could become a serious liability without the arbitrage of reciprocal compensation. Third, it **discourages economically sound facilities-based local investment and inhibits the development of an efficient competitive market.** It has the perverse effect of turning customers from assets into liabilities. Why would any competitor want to win a customer if that customer would cost them more in reciprocal compensation terminating minutes than they could earn in revenue from that customer?

What to Expect From the FCC: Investors need to appreciate that it is **not that hard for the FCC to fix this in the coming months.** ALTS, the association representing the CLECs, has an active petition (dated June 20, 1997) requesting that the FCC issue a clarification that the traffic in question is local and not interstate. ALTS argues in its petition that "this clarification is clearly in the Commission's (FCC) exclusive jurisdiction." For FCC legal authority, ALTS cites a 1980 Computer II FCC decision which was subsequently upheld in the DC Court of Appeals in 1982 and again in 1984. Now that the states have ruled the CLECs' way, the association likely regrets having requested this clarification from the FCC.

Why would the FCC believe such Internet calls are not local, but interstate? The FCC has exempted this traffic from interstate access charges for over a decade. Why would an exemption from interstate access charges be needed if the FCC thought it was a local call? Moreover, in the FCC's April 10 report to Congress, (paragraph 106) the FCC said that ISPs "are not entitled to reciprocal compensation for terminating local telecommunications traffic." However, the FCC explicitly did not comment on whether CLECs that serve ISPs are entitled to reciprocal compensation for terminating Internet traffic. They said that issue was now before the FCC. * * * * *

Attachment 2

Internet Traffic Is Not Subject to Reciprocal Compensation

As the Commission's own prior decisions make clear, calls bound for the Internet are interexchange and predominantly interstate, rather than local, and are not subject to the payment of reciprocal compensation.

1. Internet calls are not local. When a person sitting at a keyboard at home in Washington, D.C. dials in to the Internet, he or she is able to communicate with, and receive information from, other Internet users around the world. During any given call, he or she may read the day's news in the electronic version of the New York Times stored in New York City, check on breaking stories in the computers of CNN in Atlanta, and/or tap into historical archives stored half the world away in New Zealand.

Despite this fact, a number of state commissions have concluded that calls bound for the Internet should be treated as "local" calls, and should be subject to the payment of reciprocal compensation.

They have done so, in large part, based on a mistaken reading of this Commission's orders creating the so-called "ESP exemption." But those orders merely exempt Internet and other enhanced service providers from paying the interstate access charges that otherwise would apply. They do not classify the traffic as "local." On the contrary, the only reason for an exemption in the first place is that the Commission recognized that this is not local traffic – it is interexchange. If it wasn't, no exemption would be needed.

Indeed, the Commission consistently has classified this traffic as interexchange, and predominantly interstate, since its first order creating the ESP exemption and continuing through the present – reiterating the conclusion most recently in its report to Congress on universal service. See, e.g., MTS and WATS Market Structure, 97 FCC 2d 682, ¶ 78 (1983) (ESPs use "local exchange services or facilities . . . for the purpose of completing interstate calls"); id. at ¶ 83 (ESPs use "exchange service for jurisdictionally interstate communications"); Amendments of Part 69 of the Commission's Rules, 2 FCC Rcd 4305, 4306 (1987) (ESPs "like facilities-based interexchange carriers and resellers, use the local network to provide interstate services"); In re Access Charge Reform, 11 FCC Rcd 21354, ¶ 284 (ESPs use "incumbent LEC facilities to originate and terminate interstate calls"); Universal Service Report, ¶ 146 (ESPs use "local exchange networks to originate and terminate interstate services").

2. Internet calls are not two calls. Despite this unbroken chain of decisions extending over 15 years, some parties now assert that Internet calls should be treated as two separate calls, and that the first "call" to the Internet service provider should be

classified as "local." But the short answer to this claim is that it too is foreclosed by a long and consistent line of prior decisions by this Commission.

As the Commission itself has explained, when a customer calls his or her Internet service provider, the call does not stop at that point, but is instead connected to the Internet, and through it, to the caller's chosen destinations around the world. As the Commission puts it: "An end-user may obtain access to the Internet from an Internet service provider, by using dial-up or dedicated access to connect to the Internet service provider's processor. The Internet service provider, in turn, connects the end user to an Internet backbone provider that carries traffic to and from other Internet host sites." Non-Accounting Safeguards Order, 11 FCC Rcd 21905, ¶ 127, n. 291 (1996).

Under identical circumstances, the Commission consistently has held that the "nature of a call is determined by its ultimate origination and termination, and not . . . its intermediate routing." See Southwestern Bell Tel. Co., 3 FCC Rcd 2339, ¶ 26 (1988). For example, in the context of calling cards and other services where a customer first dials an 800 number and receives a second dial tone before connecting to his or her ultimate destination, the Commission repeatedly has rejected arguments that there are two calls involved. Id. at ¶ 28; see also Long Distance/USA, Inc., 10 FCC Rcd 1634, ¶ 13 (1995) ("[B]oth court and Commission decisions have considered the end-to-end nature of the communications more significant than the facilities used to complete such communications;" "[A] single interstate communication does not become two communications because it passes through intermediate switching facilities."); Teleconnect Company v. Bell Tel. of Pa., 10 FCC Rcd 1626, ¶ 12 (1995) (same), aff'd sub nom. 116 F.3d 593 (D.C. Cir. 1997).

This conclusion does not change merely because the customer has the option of dialing a local, rather than 800, number prior to being connected to his or her ultimate destination. This is no different than a call made to a Feature Group A access line to place a long distance call. Even though the caller's line and the Feature Group A line are in the same local calling area, and the customer dials a local number, the Commission always has looked to the ultimate destination to determine that calls made using these arrangements are interexchange and interstate. See, e.g., Determination of Interstate and Intrastate Usage of Feature Group A, 4 FCC Rcd 8448 (1989).

Nor does the conclusion change merely because some portion of the end to end communication may be stored locally before being retrieved by the customer. Again, the Commission has decided this very issue in the context of voice mail services, where it rejected a claim that the delivery of a voice message involves two separate, jurisdictionally distinct calls. According to the Commission, "the key to jurisdiction is the nature of the communication itself rather than the physical location of the technology," and the local storage and local delivery of a message left by an out of state caller does not change the interstate nature of the end to end communication. BellSouth Emergency Petition, 7 FCC Rcd 1619, ¶ 12 (1992), quoting New York Tel. Co. V. FCC, 631 F.2d 1059, 1066 (2d Cir. 1980). On the contrary, "an out-of-state call to [a] voice mail service is a jurisdictionally interstate communication, just as is any other out-of-state call to a person or service." Id.

Finally, the Commission's recent report to Congress on universal service does nothing to change all this. The parties who argue otherwise base their claim on the fact that the Commission said an Internet call has two distinct components, one of which is a telecommunications service and one of which is an information service. But the simple fact is that this has nothing to do with the end-to-end nature of the communication. The Commission itself expressly said as much: "We make no determination here on the question of whether competitive LECs that serve Internet service providers (or Internet service providers that have voluntarily become competitive LECs) are entitled to reciprocal compensation for terminating Internet traffic. That issue, which is now before the Commission, does not turn on the status of the Internet service provider as a telecommunications carrier or information service provider." Report to Congress, CC Dkt 96-45, at n. 220 (rel. Apr. 10, 1998) (emphasis added).

3. Internet calls are not subject to reciprocal compensation. The significance of all of this is straightforward: Because Internet traffic is not "local," it is not subject to the payment of reciprocal compensation when it is handed off to another carrier for delivery to an Internet service provider.

The Commission has firmly established that, as a matter of law, interconnecting carriers are entitled to receive reciprocal compensation only for the transport and termination of local calls. As the Commission has explained, "[t]he Act preserves the legal distinctions between charges for transport and termination of local traffic and interstate and intrastate charges for terminating long-distance traffic." Local Interconnection Order, 11 FCC Rcd 15499, ¶¶ 1033 (1996). For this reason, the reciprocal compensation obligations imposed by the Act "apply only to traffic that originates and terminates within a local calling area, as defined [by a state commission];" they "do not apply to the transport and termination of interstate or intrastate interexchange traffic." Id., ¶¶ 1034-35. This distinction between local and interexchange traffic, moreover, was upheld on appeal and is now final. Comptel v. FCC, 117 F.3d 1068 (8th Cir. 1997).

In sum, Internet-bound traffic is not local, and is not subject to the payment of reciprocal compensation.

* * * * *